South Beloit Water, Gas & Electric
Docket #01-0629
Exhibit No. 3.20

BEFORE THE

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

SOUTH BELOIT WATER, GAS & ELECTRIC COMPANY	
Re: Delivery Services Tariffs submitted pursuant to Section 16-104 and Section 16-108 of the Illinois Public Utilities Act	Docket No. 01-0629

REBUTTAL TESTIMONY OF

Enrique Bacalao

FOR

South Beloit Water, Gas & Electric Company

01-0629
3.20

SB

December 12, 2001

1/3/02

Q. Please state your name and business address.

A. My name is Enrique Bacalao and my business address is 222 West Washington Avenue, Madison, Wisconsin 53703.

Q. Please describe your educational background and current position.

A. I have a Bachelor of Arts degree in economics and a Master of Business Administration degree from Columbia University in New York. I am presently Assistant Treasurer and Director of Finance of Alliant Energy Corporation (AEC). I also serve as Assistant Treasurer of Wisconsin Power and Light Company (WPL) and of Interstate Power Company (IPC). Prior to my employment by Alliant Energy, I held the position of Vice President, Corporate Banking, in the Chicago Branch of The Industrial Bank of Japan, Limited for three years. Prior to that I served eight years in the London dealing room of the same banking institution, where I headed the corporate desk for three years after establishing the commercial paper dealing function for the bank.

Q. Did you previously provide direct testimony regarding South Beloit Water, Gas & Electric Company's (SBWGE)'s cost of equity capital and what would constitute a fair return on common equity for SBWGE?

A. Yes I did.

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my rebuttal testimony is to respond to the direct testimony prepared by ICC Staff Witness Sheena Kight in this docket.

Q. Please summarize your comments on Ms. Kight's estimate of the SBWGE cost of equity.

A. Ms. Kight's calculations do not correctly reflect the cost of common equity for SBWGE. The two samples she used to calculate equity returns - integrated electric utility companies and gas distribution companies - are not appropriate samples for the return on equity calculations.

Q. Please discuss why the samples selected by Ms. Kight are not appropriate for determining the cost of equity of SBWGE.

A. Risk-averse equity investors will want to invest in companies where the expected equity returns are commensurate with the risks of owning those investments. In a perfect market, expected returns should be the same for equity investments of a given level of risk. To achieve this equilibrium in the return vs. risk relationship, investors will look across various industries when making their investment decisions. They will not just focus on equity investments in one industry; to do so would cause them to miss favorable investment opportunities. Ms. Kight's use of a sample of integrated electric utility companies and a sample of gas distribution companies incorrectly implies that investors only have the choice of investing in one particular industry. In order to correctly determine the expected return on equity for SBWGE, a sample should be created with companies from various industries, as long as those companies have a level of risk similar to that of SBWGE.

Q. Please discuss why the sample of gas distribution companies selected by Ms. Kight is not appropriate for determining the cost of equity of SBWGE.

A. This proceeding involves electric delivery services. Gas services are not a part of this proceeding, so using a selection of gas distribution companies, in isolation, for a sample of comparables is inappropriate. Ms. Kight did not provide a reason for selecting the gas distribution companies for her sample.

Q. Please comment on the alleged "flaws" mentioned by Ms. Kight in her testimony regarding your cost of equity calculations.

A. Ms. Kight made the following comments regarding my cost of equity calculations. I will address each of these in sequence.

1) "Mr. Bacalao's sample in not representative of the risk inherent in SBWGE's electric delivery service operations."

Safety Rank as a Measure of Risk - Ms. Kight argues that the Value Line Safety Rank is an imprecise measure of risk and that to use such measure to screen for sample companies is inappropriate. She also speculates that stocks with different assigned safety numbers may be more similar in risk than stocks ranked far apart with identical assigned safety numbers.

Response: Ms. Kight's comment about the Safety Rank being an imprecise measure of risk is clearly incorrect. Page 13 of The Value Line Subscriber's Guide (EB____3.2) describes the Safety Rank as "a measure of risk avoidance" and mentions that "The Safety Rank changes infrequently and, until it does, may be taken as a forecast of relative risk avoidance". Page 17 of The Value Line Subscriber's Guide (EB____3.2) shows that the percentage declines in market value gets successively larger as risk is increased (based on Safety Rank Group 1, 2, 3, 4 and 5). The infrequency of the change in Safety Rank and the historical performance data shown on page 17 both indicate that the Safety Rank is a precise measure of risk and would be an appropriate measure to use in screening sample companies.

In addition, Ms. Kight's comment that stocks with different assigned safety numbers may be more similar in risk than stocks ranked far apart with identical assigned safety numbers is seemingly based solely on her speculation. Ms. Kight has not provided any evidence to support that this is indeed the case.

Lack of Safety Rank at SBWGE – Ms. Kight's comments on the lack of a Safety Rank for SBWGE imply that my use of the Alliant Energy Corporation Safety Rank as a proxy for the Safety Rank of SBWGE is not appropriate for selecting a sample of comparable companies. She indicates that the use of the AEC Safety Rank, if it is affected by the risks of the unregulated activities of Alliant Energy Resources, could not be used to measure the equity risk of SBWGE's electric delivery service operations on a stand-alone basis because it would reflect the risk of the unregulated affiliate.

Response: I do not agree with Ms. Kight's comments regarding the use of the AEC Safety Rank for the SBWGE analysis. There is sufficient evidence to show that the AEC Safety Rank is a good proxy for the equity risk of SBWGE. First, the Value Line Safety Rank of AEC has clearly not changed due to the non-regulated activities of AER. The Oct. 6, 2000 Value Line Report for AEC (EB____3.3) confirms that the Safety Rank has remained at "2" since the 1998 merger. Second, prior to the recent rating changes on Oct. 17, 2001, the Standard & Poor's long-term corporate credit ratings for AEC and WPL (SBWGE's parent) were relatively close at "A+" and "AA-" respectively. These measures both support a similar level of risk at AEC and SBWGE and support the usefulness of the AEC Safety Rank as a proxy for measuring the equity risk of SBWGE in selecting a number of comparable companies.

2) "Mr. Bacalao's comparable earnings methodology does not provide valid estimates of the investor-required rate of return on SBWGE's common equity."

Ms. Kight asserts that the comparable earnings methodology is flawed because it incorrectly implies that the earned book returns are equivalent to the required market returns.

Response: There is a legal basis for looking at the comparable book equity returns. As set forth by the United States Supreme Court decisions in the Hope, Bluefield and Permian Basin cases, a public utility company should be permitted an opportunity to earn a return on common equity that is sufficient to: (1) enable it to attract, on reasonable terms, the capital necessary to support its business operations and fulfill its duty to serve the public; (2) maintain and support a sound credit rating; and (3) provide a return on equity to investors that is comparable to the returns on other investments considering their relative investment risks. In order to determine if the returns indicated in (3) are achieved, it is necessary to consider the historical book equity returns of my sample companies of similar risk.

Despite differences that may occur in equity book vs. equity market values at a particular point in time, this calculation is also useful as a reasonableness test of the investor-required equity returns. Given that the data in this calculation cover a ten-year period of time, and given that the equity market values have had a significant amount of variation over that time, there would be times when book/equity ratios are higher and lower than 1.0. Over the long-run, this calculation should be used in conjunction with my other models as a check on the reasonableness of the other calculations.

3) "Mr. Bacalao's DCF analysis contains an unreasonable terminal growth rate."

Ms. Kight indicates that my use of the long-term inflation rate of 3.1% as a terminal growth rate in my DCF calculation is unreasonable. In addition, this implies that SBWGE will not experience real growth.

Response: I agree with Ms. Kight that my use of the long-term inflation rate of 3.1% as a terminal growth rate would result in no real growth and that it is implausible that SBWGE would actually experience a real growth rate of zero over such a long period of time. I used this 3.1% estimate for two reasons. First, this number is conservative as it represents a worst case scenario in which zero real growth is expected. Second, long-term growth estimates past five years are difficult to justify and can be unreliable. I recognize that a terminal growth rate in excess of the long-term inflation rate of 3.1% would be appropriate. Using a higher and more appropriate terminal growth rate in my DCF model would result in a higher cost of equity for SBWGE compared to what I show in my calculations.

4) "Mr. Bacalao's risk premium model is based on the incorrect assumption that historical risk premiums are reasonable estimates of current investor-required risk premiums."

Ms. Kight argues that the historical premiums are not reliable proxies of current or future risk premiums and as such, do not adequately measure investors' current return requirements.

Response: I agree that investor-required risk premiums should be forward looking. However, this does not necessarily imply that long-run historical risk premium data is not valid or that the results of my risk premium calculation are invalid. Comparing the historical risk premium data over a long period of time is useful as a reasonableness test of the estimated forward looking risk premium. My calculation should be used in conjunction with my other models as a check on the reasonableness of the other calculations.

5) "Mr. Bacalao's CAPM analysis is seriously flawed and does not accurately reflect the cost of equity for his sample."

Ms. Kight states that my re-levering of sample company betas to reflect the leverage of SBWGE results in higher implied risk for my sample. She also claims that because of my adjustments, many of the companies in my sample would no longer receive the same Safety Rank if such changes were made.

Response: Ms. Kight's claim of a resulting Safety Rank change is seemingly based solely on her speculation. She has not provided any evidence that this is the case. In addition, she states that the Safety Rank is a function of both operating risk and financial leverage. Page 13 of The Value Line

Subscriber's Guide (EB____3.2) indicates that the Safety Rank is based mainly on a "company's relative financial strength and the stock price's stability". The stock price stability is an additional factor not mentioned by Ms. Kight. The impact of the stock price stability on the Safety Rank adds additional complexity to the Safety Rank determination. In summary, my leverage adjustments would only impact one factor in the Safety Rank determination, so it is not a forgone conclusion that a change is the company leverage would necessarily result in a change in the Safety Rank.

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.